An Analysis of Cuno v. DaimlerChrysler And Its Possible Effects on Florida Business Location Tax Incentives

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I. Introduction

In Cuno v. DaimlerChrysler,[1] the Sixth Circuit Court of Appeals invalidated an Ohio state corporate franchise tax credit on grounds that it violated the dormant Commerce Clause of the United States Constitution. The Ohio tax credit applied to the purchase of manufacturing machinery and equipment used in the state and was intended to provide an incentive for the location or expansion of business within the state. This type of incentive falls into the general category of "business location incentives" used in various forms by nearly all states.[2]

The Cuno decision calls into question the constitutional validity of state business location tax incentives and highlights the lack of a clear standard in United States Supreme Court decisions applying the dormant Commerce Clause to such incentives. For example, some legal commentators have noted that a literal reading of the United States Supreme Court's decisions in the area suggest that "all state inducement programs are likely to be unconstitutional."[3]

At present the Cuno case has no precedential value to courts in the Eleventh Circuit, which includes Florida, because it has been decided in the Sixth Circuit. However, on September 27, 2005, the Supreme Court granted petitions for certiorari by the State of Ohio and DaimlerChrysler, challenging the Cuno decision.[4] Should the Court affirm the Cuno decision, it will become the law of the land, and similar tax incentives in Florida will be at risk of being struck down. The State of Florida has filed an amicus curiae brief in Cuno, on behalf of 31 other states, asking the Supreme Court to clarify the application of its dormant Commerce Clause precedent.[5] The Court should issue a ruling in the summer of 2006.

There is also legislation pending in both houses of Congress to preserve tax incentive programs similar to Ohio's. Senator George Voinovich and Representative Patrick Tiberi have filed Senate Bill 1066 and House Resolution 2471, respectively, and both bills have been referred to committee. However, no action has been taken since the bills were referred to committee in May 2005.

This white paper will summarize the Cuno decision and provide a framework for analysis of its possible effects on Florida business location incentives.

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[1] Cuno v. DaimlerChrysler, 386 F.3d 738 (6th Cir. 2004).
[2] There are approximately 37 states with tax incentives similar to the Ohio investment tax credit. Petition for Writ of Certiorari of William W. Wilkins (Supreme Court Case No. 04-1724), at 22.
[3] Walter Hellerstein and Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 Cornell L. Rev. 789, 802 (1996). This article is the apparent source of the Cuno court's analysis. Petition for Writ of Certiorari of William W. Wilkins, (Supreme Court Case No. 04-1724), at 4 (citation omitted).
[4] Case Nos. 04-1704 and 04-1724 have been consolidated. The Petitioners have also been directed to brief the issue of the Respondents' (the original plaintiffs) standing to challenge the Ohio investment tax credit.
[5] Brief of Amici Curiae State of Florida et al., (Supreme Court Case No. 04-1724).

II. Cuno Factual Background

In 1998 the City of Toledo, Ohio entered into an agreement with DaimlerChrysler for the construction of a new vehicle assembly plant near an existing facility and offered the auto manufacturer a number of tax incentives. DaimlerChrysler estimated that it would invest $1.2 billion in the project. In return, the City, with the approval of two local school districts, gave DaimlerChrysler a 10-year, 100 percent property tax exemption as well as an investment tax credit of 13.5 percent against the state corporate franchise tax for qualifying investments. These incentives totaled $280 million.[6]

A. The Investment Tax Credit

The Ohio Investment Tax Credit (ITC) grants a taxpayer a non-refundable credit against the state's corporate franchise tax if the taxpayer "purchases new manufacturing machinery and equipment during the qualifying period, provided that the new manufacturing machinery and equipment are installed in [Ohio]."[7]

The investment tax credit is normally 7.5 percent "of the excess of the cost of the new manufacturing machinery and equipment purchased during the calendar year for use in a county over the average new manufacturing machinery and equipment investment for that county."[8] The rate increases to 13.5 percent of the cost of the new investment if it is purchased for use in specific economically depressed areas.[9] The credit is capped at $1 million unless the taxpayer has increased its overall ownership of manufacturing equipment in the state during the year for which the credit is claimed.[10]

B. The Property Tax Exemption

The Ohio enterprise zone program permits municipalities to offer incentives to an enterprise that "agrees to establish, expand, renovate, or occupy a facility and hire new employees, or preserve employment opportunities for existing employees" in economically depressed areas.[11]

A property tax exemption may be granted up to 10 years for up to 75 percent of "the assessed value of the tangible personal property first used in business at the project site as a result of the agreement."[12] The exemption may exceed 75 percent only with the consent of the affected school districts.[13]

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[6] Cuno, 386 F.3d at 741.
[7] Id. (quoting Ohio Rev. Code Ann. s. 5733.33(B)(1)). The Ohio ITC is similar to Florida's capital investment tax credit. See. s. 220.191, F.S.
[8] Cuno, 386 F.3d at 741 (quoting Ohio Rev. Code Ann. s. 5733.33(C)(1)).
[9] Id. (citing Ohio Rev. Code Ann. s. 5733.33(C)(2), (A)(8)-(13)).
[10] Id. (citing Ohio Rev. Code Ann. s. 5733.33(B)(2)(a)).
[11] Id. (quoting Ohio Rev. Code Ann. s. 5709.62(C)(1)).
[12] Id. (quoting Ohio Rev. Code Ann. s. 5709.62(C)(1)(a)).
[13] Cuno, 386 F.3d at 742 (citing Ohio Rev. Code Ann. s. 5709.62(D)(1)).

C. Lower Court Ruling

The plaintiffs filed suit in state court, challenging the ITC and personal property tax exemption on grounds that they discriminated against interstate commerce by granting preferential treatment to in-state investment in activity, in violation of the Commerce Clause of the United States Constitution and the Equal Protection Clause of the Ohio Constitution.[14]

The case was removed to federal court, which dismissed the complaint, holding that the ITC and the property tax exemption did not violate the Commerce Clause "because, although 'an increase in activity in Ohio could increase the credit and exemption amount' under the two statutes, an increase in activity *outside* the state would not *decrease* the amount of the tax credit or exemption…"[15] The plaintiffs appealed the decision to the Sixth Circuit Court of Appeals.

III. Brief Summary of Commerce Clause Requirements

The Commerce Clause of the United States Constitution expressly authorizes Congress to regulate commerce with foreign nations and among the states.[16] The courts have recognized that the "dormant" aspect of the Commerce Clause implicitly limits the states' right to tax interstate commerce.[17] A state tax provision will satisfy the requirements of the Commerce Clause if:

1. The activity taxed has a substantial nexus with the taxing state;
2. The tax is fairly apportioned to reflect the degree of activity that occurs within the state;
3. The tax does not discriminate against interstate commerce; and
4. The tax is fairly related to benefits provided by the state.[18]

As a general rule, a tax credit or exemption will violate the dormant Commerce Clause if it discriminates on its face or if, on the basis of "a sensitive, case-by-case analysis of purposes and effects," the provision "will in its practical operation work discrimination against interstate commerce" by "providing a direct commercial advantage to local business."[19] The high court has defined "discrimination" in this context to mean the "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter."[20]

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[14] Id. at 741.
[15] Id. at 742 (emphasis in original).
[16] U.S. Const. art. I, s. 8.
[17] Cuno, 386 F.3d at 742.
[18] Id. 742 (citing Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977)).
[19] Id. at 743 (quoting West Lynn Creamery v. Healy, 512 U.S. 186, 201 (1994)).
[20] Id. (quoting Oregon Waste Sys., Inc. v. Dep't of Envtl. Quality, 511 U.S. 93, 99 (1994)).

There are exceptions to the general rule against discrimination in cases where (1) an otherwise discriminatory tax provision "advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives;"[21] (2) the state acts as a market participant;[22] and (3) when the state provides cash subsidies.[23]

IV. The Cuno Court's Analysis

A. The Investment Tax Credit

The Sixth Circuit's analysis ostensibly turns on three Supreme Court cases: Boston Stock Exchange v. State Tax Commission,[24] Maryland v. Louisiana,[25] and Westinghouse Electric Corporation v. Tully.[26]

In Boston Stock Exchange, the Supreme Court invalidated an amendment to the New York securities transfer tax designed to offset a competitive advantage held by out-of-state stock exchanges that did not tax transfers of securities.[27] Prior to the amendment's adoption, New York had taxed in-state transfers of securities without regard to the place of sale.[28] The amendment reduced the tax rate on transfers by nonresidents and limited tax liability for transfers of large blocks of shares as long as the sales were made in New York.[29] The amendment's effect was to increase the tax on out-of-state sales compared to in-state sales.[30]

The Court held that the amendment violated the Commerce Clause because it converted what had been a neutral tax as to the location of the sale into one that would induce a seller to trade through a New York broker in order to reduce its tax liability.[31] This created an advantage for New York exchanges and placed a discriminatory burden on commerce to other states.[32] The Court stated that New York's use of its taxing power to coerce other business operations to be performed in the state was "wholly inconsistent with the free trade purpose of the Commerce Clause."[33]

In Maryland v. Louisiana, the Court struck down a Louisiana statute imposing a first-use tax on natural gas extracted from the continental shelf in an amount equivalent to the severance tax imposed on natural gas extracted in Louisiana.[34] Taxpayers subject to the

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[21] Id. (quoting Oregon Waste Sys., Inc. v. Dep't of Envtl. Quality, 511 U.S. 93, 101 (1994)(citation omitted)).
[22] Hughes v. Alexandria Scrap Corp., 426 U.S. 794 (1980).
[23] White v. Massachusetts Council of Construction Employers, 460 U.S. 204 (1983).
[24] 429 U.S. 318 (1977).
[25] 451 U.S. 725 (1981).
[26] 466 U.S. 388 (1984).
[27] 429 U.S. at 323-324.
[28] Id. at 322.
[29] Id. at 324.
[30] Id. at 330-331.
[31] Id. at 330-332.
[32] Boston Stock Exchange, 429 U.S. at 331.
[33] Id. at 336 (citation omitted).
[34] Id. at 731.

first-use tax were allowed a credit on any Louisiana severance tax owed in connection with the extraction of natural resources within the state.[35] Most Louisiana consumers of offshore gas were eligible for tax credits and exemptions, but the tax applied in full to offshore gas moving through and out of the state.[36] A company producing offshore gas would be subject to the tax unless it received a credit against the tax for the extraction of natural resources within Louisiana.

The Court noted that the statute's effect was to encourage natural gas owners involved in offshore production to invest in mineral exploration and development within Louisiana instead of investing in additional offshore development or in production in other states.[37] Because of this, the Court found that the statute "unquestionably discriminate[d] against interstate commerce in favor of local interests."[38]

In Westinghouse Electric Corporation v. Tully, the Court struck down a New York franchise tax that gave corporations an income tax credit based on the portion of their exports shipped from New York. In an attempt to increase the volume of exports from New York, the parent of an exporter could receive a credit against its franchise tax attributable to the subsidiary's income generated from New York exports.[39] Because the tax credit was based on the ratio of the subsidiary's New York exports to its income from all exports, a parent company's total New York tax liability would decrease as exports from New York increased relative to exports from other states, and conversely, its tax liability would increase as exports from New York decreased relative to total exports from other states.[40]

The Court concluded that the tax "foreclosed tax-neutral decisions" and created an advantage for businesses operating in New York by placing "a discriminatory burden on commerce to its sister States."[41]

In construing these cases, the Cuno court appears to have adopted the argument of the Plaintiffs-Appellants, which was that the ITC "discriminates against interstate economic activity by coercing businesses already subject to the Ohio franchise tax to expand locally rather than out of state."[42] The court explained the Plaintiffs'-Appellants' argument further:

> [A]ny corporation currently doing business in Ohio, and therefore paying the state's corporate franchise tax in Ohio, can reduce its existing tax liability by locating significant new machinery and equipment within the state, but it will receive no such reduction in tax liability if it locates a comparable plant and equipment elsewhere. Moreover, as between two

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[35] Maryland v. Louisiana, 451 U.S. at 732.
[36] Id. at 733.
[37] Id. at 756-57.
[38] Id. at 756.
[39] 466 U.S. at 393.
[40] Id. at 401.
[41] Id. at 406 (quoting Boston Stock Exchange, 429 U.S. at 331).
[42] 386 F.3d at 743.

> businesses, otherwise similarly situated and each subject to Ohio taxation, the business that chooses to expand its local presence will enjoy a reduced tax burden, based directly on its new in-state investment, while a competitor that invests out-of-state will face a comparatively higher tax burden because it will be ineligible for any credit against its Ohio tax.[43]

Apparently based on this argument and without further explanation, the Cuno Court concluded that "Ohio's investment tax credit cannot be upheld under the Commerce Clause of the United States Constitution."[44] It appears that the court adopted the argument that because the Ohio investment tax credit encouraged in-state investment "at the expense of development in other states,"[45] it discriminated against free trade.

The Cuno court's failure to more clearly explain its opinion makes it difficult to analyze its potential effects on state business location tax incentives. This may be due in part to the case-by-case nature of dormant Commerce Clause decisions of the Supreme Court and the lack of a bright line for determining when a particular incentive violates the Constitution.[46] Some legal scholars have attempted to delineate a better framework for determining the constitutionality of tax incentives, but it remains to be seen whether the high court will adopt a clearer standard.[47]

B. The Property Tax Exemption

The Cuno court upheld the enterprise zone property tax exemption on grounds that the conditions imposed on the exemption were "minor collateral requirements...directly linked to the use of the exempted personal property."[48] The court noted that the law required an investment in new or existing property within an enterprise zone and maintenance of employees, but did not "impose specific monetary requirements, require the creation of new jobs, or encourage a beneficiary to engage in an additional form of commerce independent of the newly acquired property."[49]

Because the law did not impose these additional requirements, the court held that the conditions placed on eligibility for the exemption did not "independently burden interstate commerce."[50]

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[43] Id.
[44] Id. at 746.
[45] Id. at 745.
[46] The Cuno court noted that the United States Supreme Court has "never precisely delineated the scope of the doctrine that bars discriminatory taxes." 386 F.3d at 743.
[47] Hellerstein and Coenen have proposed a standard based on the "state coercion" rationale, which suggests that a court declare a tax incentive unconstitutional if it favors in-state over out-of-state activities and if it implicates the coercive power of the state. See 81 Cornell L. Rev. at 806.
[48] 386 F.3d at 747.
[49] Id.
[50] Id.

V. Applying the Cuno Rationale in Florida

A. General State Tax Incentives

Under Cuno, the constitutional challenge that a tax incentive faces will turn on whether the taxpayer is subject to the state's taxing power and whether the tax incentive favors in-state as opposed to out-of-state activities. The Cuno test may be explained as follows:

1. Is the business subject to Florida's taxing power?

2. Will the business reduce its Florida tax liability by availing itself of the tax incentive for location or expansion of business in Florida and not by locating or expanding business activity out-of-state?

   -or-

   Will its location or expansion of business activity out-of-state result in a comparative tax increase, as to a similarly-situated business expanding in Florida, because it will not be able to avail itself of the in-state tax incentive?

If the answers to questions 1 and 2 are "yes," the tax incentive likely fails the Cuno test.[51]

It is possible that many state business location tax incentives could fail this test, since they are designed to offer a state tax benefit to a business that locates or expands business activities within the state. Should a business that is subject to tax decide to locate or expand business activities outside the state, it would of course not be able to take advantage of the state's tax incentives for the out-of-state business activities.

B. Enterprise Zone Incentives

The Cuno analysis also puts the Florida Enterprise Zone Act at risk because it upholds incentives that are conditioned on the use or location of property if they are not conditioned on a business undertaking activity that is "independent" of the acquired property, such as imposing specific monetary requirements, requiring the creation of new jobs, or requiring the business to engage in a new form of commerce independent of the property.

The Florida Enterprise Zone Act provides for a number of incentives that require such "independent" activity, such as the jobs credit against the sales tax[52] and jobs credit against the corporate tax,[53] which require the creation of new jobs; and the business property tax exemptions,[54] which require the business to meet minimum expense thresholds before they apply.

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[51] For example, the Capital Investment Tax Credit, s.220.191, F.S., because of its similarity to the Ohio ITC, likely fails the Cuno test.
[52] s. 212.096, F.S.
[53] s. 220.181, F.S.
[54] ss. 212.08(5)(g), (h), F.S.

This may be a less serious issue than the primary Cuno decision, because the Supreme Court has not granted the Cuno plaintiffs' petition for certiorari on the question of the correctness of the Sixth Circuit's opinion upholding the enterprise zone incentives. If the Court refuses to grant the petition, the Cuno decision with respect to enterprise zone incentives will be controlling only in the Sixth Circuit and will not apply in Florida.

C. Other Incentives

The Cuno case did not address the constitutionality of state subsidies, grants or tax refunds and therefore programs offering these benefits should generally be permissible.[55]

VI. Conclusion

The Cuno decision has called into question virtually all state business location tax incentives. Proposed incentives should be carefully reviewed against this decision until the Supreme Court clarifies dormant Commerce Clause law in this area.

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[55] Florida offers a number of these incentives, including the Qualified Defense Contractor Tax Refund, s. 288.1045, F.S.; the Qualified Target Industry Tax Refund, s. 288.106, F.S.; Economic Development Transportation Fund projects authorized in s. 288.063, F.S., and SA 2510, ch. 2005-70, L.O.F.; the High Impact Performance Grant, s. 288.108, F.S.; and the Quick Action Closing Fund, s. 288.1088, F.S. The Supreme Court has distinguished subsidies from the kinds of tax incentives that violate the dormant Commerce Clause. See New Energy Co. of Ind. v. Limbach, 486 U.S. 269, 278 (1988).